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Newsletter
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In January we introduced the concept of “Multi-Scenario Investing”. Under Multi-Scenario Investing you choose investments based on more than one possible economic scenario and for which you want to benefit from or you want to protect yourself against. For example you would add stocks to a portfolio to benefit from potential long term economic growth, government bonds to protect against a potential depression, and gold related assets to protect against a potential loss in the value of currencies. In total you might have five or more asset classes each chosen to work well in a different economic scenario. The challenge is determining which asset class and how much to include.

This approach is subtly different than traditional investing which uses diversification and seeks out asset classes with low correlations (they typically move differently). It is based on the premise that the world is extremely uncertain, there are multiple outcomes possible (inflation, deflation, boom, bust, etc.) that could occur, that protection of principle in most cases is more important than making a killing by betting heavily on one scenario and, that portfolios should be composed of asset classes that will do well under different scenarios. Multi-Scenario Investing has served us well and we continue to use it in our portfolio management. Most of the rest of this letter describes the wild world we are in and, hopefully, you will see why we think Multi-Scenario Investing makes sense.

The downward plunge of the economy seems to be ending and if we haven't reached bottom, hopefully this will occur soon. The good news is that it looks like we avoided a full blown depression, but it has been a dramatic downturn and many are calling it the “Great Recession”. Actions taken by governments around the world to stem the drop are unprecedented and we continue to argue that as we move beyond the recovery stage we will enter a “New World”. One of the biggest changes is the dramatic shift in the role between government and business. This will affect the economy for years to come and affects investing.

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Investors continue to change their views on where the economy is going. This is the reason for the stock market volatility. Corporate bonds, commodity and gold investments have been strong after the plunge in confidence ended late last fall when investors shunned all assets except government bonds and government insured cash accounts. After the 34 to 40 percent drop last year in the major US stock averages (Dow Jones Industrial Average and S&P 500 Index), this year we saw a further 25 percent drop that was then followed by a breath taking rally of almost 40 percent from their lows. The markets' sharp drop initially priced in a depression, and then as the odds of a depression occurring lessened, the markets strongly rallied. Some of those we listen to argue that even after the recent gains the markets still have not priced in an economic recovery which is a possible reason for stock markets to go up from here. All the news is not bad.

Another interesting line of reasoning with positive overtones is that as the Great Recession was unfolding, companies were extremely quick to reduce expenses. They are now running very lean and their profit margins are much higher than is normal with such a deep recession. The argument then goes that the companies may maintain their cautious posture (only slowly increasing hiring) as the economy recovers which could result in a surprising, strong rebound in profits. This could be very positive for stocks. From a social standpoint, companies making large profits while unemployment remains high could lead to added tension between the haves and have-nots. Note the bad press Goldman Sachs received when it reported large profits.

Another fascinating trend, longer term in nature, is the changing role of China in the world. Some argue that decisions made in China may have a larger impact on the world economy than those made here in the United States. This may be the first time the US does not lead the world recovery as China may have this distinction.

We are fascinated by the upward movement in commodity prices while overall inflation is virtually non-existent. (Inflation is held in check when industry has so much over-capacity and unemployment levels are high). A possible explanation goes like this: Huge imbalances have developed between the economies of China and the US. (China is becoming wealthier at the expense of the US- note the amount of US debt owned by China.) Normally, the imbalances would be corrected through currency adjustments, but China restricts these changes. Commodities, on the other hand, are traded on the global market and their prices are not controlled by China. Higher commodity prices may be a partial escape valve for the tremendous tensions caused by the global imbalances.

As we said at the beginning, uncertainty is unusually high. Our projections on what may happen may be totally wrong. Financial systems are extraordinarily complex. Simple linear explanations (cause and effect) typically don't work. The high level of uncertainty is why we think the "Multi-scenario Investment Strategy is so important.

Multi-scenario investing does not assure a profit nor protect against a loss. Investments mentioned may not be suitable for all investors. Keep in mind that while stocks have more of a potential for growth, they are also riskier than bonds. Gold is subject to the special risks associated with investing in precious metals, including but not limited to: price may be subject to wide fluctuation; the market is relatively limited; the sources are concentrated in countries that have the potential for instability; and the market is unregulated. Commodities are volatile investments and should only form a small part of a diversified portfolio. There may be sharp price fluctuations even during periods when prices overall are rising. Commodities are generally considered speculative because of the significant potential for investment loss. Please note that international investing involves special risks, including currency fluctuations, differing financial accounting standards, and possible political and economic volatility. Individual investor's results will vary. Past performance does not guarantee future results.

The S&P 500 is an unmanaged index of 500 widely held stocks that's generally considered representative of the U.S. stock market. The DJIA is an unmanaged index of 30 widely held stocks. Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance.